IN THE

Supreme Court of the United States

OCTOBER TERM, 1946.

NOS. 674 AND 675

COMMISSIONER OF INTERNAL REVENUE,
Petitioner,

v.

SIDNEY S. MUNTER.

COMMISSIONER OF INTERNAL REVENUE,
Petitioner,

v.

CARL MUNTER.

On Writs of Certiorari to the United States Circuit Court of Appeals for the Third Circuit.

BRIEF FOR THE RESPONDENTS.

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BRIEF FOR THE RESPONDENTS.

OPINIONS BELOW.

The opinion of the Tax Court (R. 20-29) is reported in 5 T. C. 108, and the opinion of the Circuit Court of Appeals (R. 41-46) is reported in 157 F. 2d 132.

JURISDICTION.

The jurisdiction of this Court rests upon Section 240 (a) of the Judicial Code, as amended.

STATEMENT OF THE QUESTION.

A new corporation was formed in 1928 to acquire the business of two existing corporations. A majority of the new company's stock was sold to new interests for cash. The new company acquired the assets of the old companies in exchange for the remaining shares (a minority) of the new company and about 75 percent of the cash supplied by the new interests. This cash, paid to some of the shareholders of the larger predecessor, was more than the earnings and profits of the larger predecessor but less than the combined earnings and profits of both predecessors. The new corporation made a distribution to its shareholders in 1940, when it had no earnings or profits of its own. The question is whether the 1928 distribution to old shareholders of cash contributed by new shareholders precludes treatment of the earnings of both predecessors as earnings of the new company available for distribution as a 1940 dividend.

STATEMENT OF THE CASE.

The proceedings are for review of decisions of The Tax Court of the United States determining deficiencies in income taxes for the calendar year 1940 in the respective amounts of $8,175.50 and $9,596.33.

On March 21, 1940 each of the respondents acquired by purachse from O. McKenize at the price of $8.00 per share 10,000 shares of the capital stock of Crandall-McKenzie & Henderson, Inc., a Pennsylvania corporation, out of a total of 38,922 shares issued and outstanding (exclusive of 11,078 shares of treasury stock) at the price of $8.00 per share. (R. 8-9; 21)

On June 19, 1940, Crandall-McKenzie & Henderson, Inc. distributed to its shareholders cash in the amount $35,166.25 at the rate of $1.25 per share of which each respondent received $12,500 with respect to the 10,000 shares held by him. (R. 9, 21)

Crandall-McKenzie & Henderson, Inc. at December 31, 1939 had no earnings or profits accumulated from December 4, 1928 to December 31, 1939, and it had no earnings or profits in its taxable year January 1, 1940 to December 31, 1940. (R. 9, 21)

The respondents treated the 1940 distribution as a non-taxable return of capital under section 115(d) of the Internal Revenue Code. The petitioner included it in income as a dividend out of earnings and profits acquired from predecessor corporations in 1928. The Tax Court sustained the petitioner's determination, with a dissenting opinion by Disney, J. (R. 20, 27) On review, the Circuit Court of Appeals reversed the Tax Court (R. 41, 47), with a dissenting opinion by O'Connell, C. J. (R. 44)

Crandall-McKenzie & Henderson, Inc. (new company) had been formed in December, 1928 pursuant to an agreement between K. W. Todd & Company, investment bankers, and O. McKenzie and L. Henderson, shareholders of two corporations, Crandall-McKenzie Company and L. Henderson & Sons, Inc. (the old companies). Upon consummation of the December, 1928 transaction the new company had acquired substantially all the assets of the old companies in exchange for 24,131 shares of capital stock of the new company and $355,247.75 in cash and the remaining 25,869 shares in the new com-

pany had been issued to new interests for cash in the amount of approximately $486,893.92. (R. 21)

All the assets of one of the old companies, L. Henderson & Sons, Inc., were acquired by the new company in the 1928 transaction solely in exchange for 9,524 shares of the new company. At the time of this transaction L. Henderson & Sons, Inc. had earnings and profits of $74,743.62 accumulated subsequent to March 1, 1913. (R. 21)

The assets of the other old company, Crandall-McKenzie Company (for convenience called "Crandall"), were acquired by the new company in the 1928 transaction in exchange for 14,607 shares of the new company and $355,247.75 in cash. The holders of 1017.5 shares of Crandall, par value $10.00 per share, out of a total of 2060 shares, received $355,217.75 in cash in full for their 1017.5 shares. The holders of the remaining 1042.5 shares of Crandall received the 14,607 new company shares (and $30.00 cash) in exchange for their shares. At the time of this transaction Crandall had earnings and profits accumulated subsequent to March 1, 1913, in the amount of $329,267.95. (R. 11-14; 21)

O. McKenzie received 12,181 shares of the new company in exchange for 842½ shares of Crandall or 14.46 shares for one and J. L. Brown and A. J. Kapp each received 1,213 shares of the new company plus $15.00 for 100 shares of Crandall or 12.13 shares plus 15 cents for one. (R. 13-14)

A. E. Crandall received $300,000 in cash for 842½ shares of Crandall, or $356.00 plus per share and the holders of the remaining 175 shares of Crandall received cash at the rate of $315.53 per share, as to 25 shares by

sale to the new company and as to 150 shares from the liquidating trustees of Crandall. (R. 22, 12, 13)

The sole question is whether under the undisputed facts the new company, on its organization in 1928, acquired the earnings and profits of both old companies as its earnings and profits.

ARGUMENT.

Summary of Argument.

The decisions of the Circuit Court of Appeals for the Third Circuit in *Campbell v. U. S.*, 144 F (2d), 177 and in this case are correct. They are not in conflict, either in principle or on their facts, with any decision cited by the petitioner.

It is not necessary for this Court to decide in this case whether the circumstance of transfer in reorganization to a new corporation controlled by new interests is alone sufficient to justify conversion of predecessor earnings into transferee capital. Nor is it necessary to decide whether such circumstance is sufficient to prevent operation of the tax-free reorganization provisions of the governing statutes. Doubting that the 1928 transaction would meet the tests of the decisions of this Court, counsel for the respondents merely assume, without admitting, that the 1928 transaction was tax-free to those shareholders who received stock for stock. The real question is whether the transfer of control to new interests, largely for cash, accompanied by distribution of the cash to transferor shareholders, precludes application of the rule of transfer of earnings in reorganization. The Circuit Court decision does not rest solely

on the lack of identity of proprietary interest, as argued by the petitioner. On the contrary it rests squarely on the effect of the 1928 cash transactions.

The 1928 transaction in the present case was more of the nature of a cash purchase than a reorganization, with the result that more than the entire earnings of the larger predecessor were distributed in cash to its shareholders in 1928. The same earnings cannot be distributed a second time in 1940. The 1928 transaction, whether or not it was a reorganization, was not tax-free to the shareholders who received cash for their shares. On the contrary, their gain would be recognized in full.

The *Sansome* rule, about which the petitioner is so gravely concerned, is not violated by the Circuit Court decision in this case. That rule, and the statutes on which it is based, are designed to prevent conversion of earnings into capital in situations where there is a tax-free intercorporate exchange of *assets for securities*. The statutes do not include sales for cash in the tax-free provisions. Cash payments to shareholders in reorganization give rise to gain recognizable to the full extent of the cash and constitute distributions of earnings and profits. The Tax Court missed this point and thus failed to reach the inevitable conclusion that the 1928 distribution of cash was out of earnings and profits.

The majority of the Circuit Court held that separate treatment of the earnings of Henderson, the smaller predecessor, not distributed in cash in 1928, is not justified because the "reorganization" of both predecessors was a single transaction. The dissenting Judge in the Circuit Court, conceding that Crandall's earnings were "possibly" distributed in 1928, concluded that Henderson's earnings were transferred tax-free in reorganiza-

tion and suggested remand for determination whether Henderson's earnings alone were sufficient to cover the disputed 1940 distribution. The facts from which this determination could be made are in the record, and the point was argued to the Tax Court. It must be assumed that the Tax Court concluded that Henderson's earnings alone were not sufficient, making it necessary in sustaining the tax to include Crandall's earnings.

The governing statutes and regulations do not permit any doubt that the 1928 cash distribution was out of earnings. The Tax Court decision is clearly contrary to the law and the decision of the Circuit Court of Appeals should be affirmed.

The "Sansome" rule does not apply to distributions of money in reorganization.

The *Sansome* case (60 F. (2d) 931) was decided in 1932 under the Revenue Act of 1921. (42 Stat. 228) It merely held that, for income tax purposes, earnings of one corporation do not become capital of another in a case where the old and the new corporations are identical. The Courts have uniformly held, under all later Revenue Acts, that earnings of one corporation do not become capital of another in comparable situations, where on reorganization all shareholders of the transferor corporation or corporations receive *only* securities of the transferee corporation. In none of the cases cited by the petitioner was there in the "reorganization" a purchase by a transferee corporation out of cash capital contributed by new controlling interests of the transferee corporation, accompanied by a distribution of cash to shareholders of a transferor. There is therefore no need to discuss the cases cited by the petitioner.

There is statutory basis for this rule in Section 203(g) of the Revenue Act of 1924, 43 Stat. 253, (Appendix page 17); Section 112(h) of the Revenue Act of 1928, 45 Stat. 791 (Appendix page 22); Section 112(h) of the Revenue Act of 1932, 47 Stat. 169 (Appendix page 26); Section 115(h) of the Revenue Act of 1934, 48 Stat. 680 (Appendix page 27); Section 115(h) of the Revenue Act of 1938, 52 Stat. 447 (Appendix page 28); and Section 115(h) of the Internal Revenue Code (Petitioner's brief page 39).

As explained in Congressional reports, prior to the 1924 Act some distributions of securities in reorganization were taxable as dividends and affected availability of earnings for future distribution. Section 203(c), Revenue Act of 1924 (Appendix page 17), Report of Ways and Means Committee, 68th Congress, 1st Session, H. Rept. 179, pages 14 and 16 (Appendix page 17).

All of the statutes prior to the 1938 Act related only to distributions of stock or securities. Section 115(h) of the 1938 Act included "money" received without recognition of gain:

"In view of the fact that Sections 112(b)(6) and (), permit the distribution of property (including money) in addition to stock or securities, without the recognition of gain to the distributee, * * *." (75th Congress, 3rd Session, S. Rept. 1567, page 19; see also change with respect to money in 112(b)(6), Appendix pages 27 and 28).

The distinction, in treatment of money, between reorganizations on the one hand and liquidations on the other appears clearly in Section 19.115-11 of the regulations printed in full in the appendix to this brief (Pages

37 to 40). Paragraphs (2), (3) and (4) should be read in connection with petitioner's statement on page 21 of his brief that the words "property or money" were added after the phrase "stock or securities." The statutory sanction of the *"Sansome"* rule on which petitioner relies does not, therefore, apply to distributions of money in connection with a reorganization.

There is no statute, regulation or decision under which a distribution of money in connection with a reorganization, is not recognized as a distribution of earnings or profits of a corporation.

The decision of the Circuit Court rests on the 1928 cash transactions.

The decision of the Circuit Court of Appeals in this case does not rest "solely on the lack of identity of proprietary interest" nor on "the mere fact that new stockholders acquire for cash a stock interest in the successor corporation" as argued by the Government. (Petitioners' brief, pp. 26-27) The Circuit Court explains the grounds of its decision as follows: (R. 44)

> "As seen the new corporation not only differed radically from its two predecessors but actually paid out in cash to one of them more than the latter's earnings and profits though less than the combined earnings and profits of both old corporations * * *"

The vital facts so tersely summarized cannot be disputed. Based on the stipulation of the parties (R. 9-14), the Tax Court found (R. 21):

> In 1928 the new corporation "acquired all the assets of the two named predecessor corporations

in exchange for 24,131 shares of its capital stock and $355,247.75 in cash. This stock and cash were received by stockholders of the two predecessor companies for their stock therein. The remaining 25,869 shares in the new company were issued to new interests for cash in the amount of approximately $486,893.92. • • •

"The assets of (Crandall) the other predecessor corporation • • • were acquired by the new company, Crandall-McKenzie, for 14,607 shares of its stock and $355,247.75 in cash. At the time of this transaction Crandall had earnings and profits accumulated subsequent to March 1, 1913 in the amount of $329,267.95." The other predecessor (Henderson) whose shareholders received no cash, had accumulated earnings and profits of $74,743.62. The combined post 1913 earnings and profits of both old corporations were $404,011.57 and shareholders of the one received $355,247.75 in cash from the new corporation.

Under these circumstances, the new corporation was so different from the old as to preclude any idea of transferred earnings.

The tax Court missed the point.

The Tax Court missed the point inherent in these facts. It correctly concluded that in the 1928 transaction "the participating stockholders of the old corporations exchanged their stock in the old corporations for stock in the new company and money." (R. 2) But it failed to follow through with the conclusion that the money constituted a distribution of the earnings and profits of the old companies. After pointing out that

recognizable gain is a prerequisite to a distribution of a taxable dividend (earnings), it stated that the record is lacking in proof of the cost of the old stock in the hands of the stockholders who received the cash so that it could not determine the *amount* of the gain. (R. 26) On this reasoning it found that the earnings of both predecessor corporations were taken over in toto by the new corporation. (R. 27)

The point which the Tax Court missed is that the tax nature of a corporate distribution is determined from the point of view of the distributing corporation, rather than of the distributee shareholders. The governing statutes and regulations require the conclusion that the 1928 cash payments constituted a distribution of earnings and profits, regardless of the cost of the shares in the hands of the distributee shareholders.

A shareholder who on reorganization of a corporation receives cash for his interest is party to a taxable transaction, whether or not the gain of other shareholders is recognized on an exchange of stock for stock in the same transaction. As between the distributing corporation and the non-participating shareholder who receives cash, there is a distribution of earnings and profits.

Crandall's earnings were distributed in cash in 1928.

On the Government's own theory of the case, the issue narrows down to the question whether the 1928 cash distribution was a distribution of earnings or profits. There is no discussion of this point in the Government's brief other than the statement (footnote p. 25)

that the "Tax Court assumed, in the absence of proof to the contrary, that the Crandall stockholders realized no gain."

The question is not whether a particular shareholder realized gain, but rather whether gain (if any) on the transaction is *recognizable* in law. Thus it does not matter how much the particular shareholder paid for his shares. The taxable character of the transaction is determinable without proof of the cost to Crandall and the other non-participating shareholders. The gain, if any, to them is *recognized* in full, because they received only cash for their shares.

If the 1928 transaction was a reorganization, the cash distribution to Crandall shareholders, to the extent of the accumulated earnings and profits of the old company, had the effect of the distribution of a taxable dividend. *Revenue Act of 1928*, Sec. 112 (c) (1) and (2); *Commissioner v. Estate of Bedford*, 325 U.S. 283; *Estate of John B. Lewis v. Commissioner*, 6TC 455.

If the 1928 transaction was not a reorganization and the cash distribution to the retiring shareholders of Crandall was in complete or partial liquidation of the old company, the part of the distribution not properly chargeable to capital account must "be considered a distribution of earnings or profits * * * for the purpose of determining the taxability of subsequent distributions by the corporation." *Revenue Act of 1928*, Sec. 115 (c) (Appendix p. 25); *Reg. 103*, Sec. 19.27 (g) (Appendix p. 35); *Reg. 103*, Sec. 19.115-2 (Appendix p. 33); *Reg. 103*, Sec. 19.115-11 (Appendix p. 37); *Helvering v. Jarvis*, 123 F. (2d) 742; *Helvering v. Credit*

Alliance Corp., 316 U.S. 107; *Commissioner v. Sansome*, 60 F.(2d) 931; compare *Foster v. U. S.*, 303 U.S. 118.

The record shows that the holders of 1017½ shares of old company stock receiving cash of $355,245.75. (R. 11-14). The par value of these shares was $10,175.00. (R. 9) The earnings and profits accumulated before and after March 1, 1913 were $345,298.49. (R. 14) It is clear that the distribution to the old shareholders exhausted all capital allocable to their shares ($10,175.00) and all Crandall's accumulated earnings.

Paraphrasing the statement of Disney, J., in the dissenting opinion of the Tax Court, (R. 28) the result here is the same as if the old company kept its earnings and profits and paid them out to its own shareholders. The new company would then have retained the cash capital contributed by the new shareholders and the payment here in dispute would clearly be from that cash capital.

Separate treatment of Henderson's earnings.

The Tax Court in its opinion did not discuss the possible result of the transfer to the new corporation, *qua* earnings, of the earnings of the smaller predecessor, L. Henderson and Sons, Inc. The possibility is discussed in the dissenting opinion of O'Connell, C. J. (R. 46)

The record shows and the Tax Court found, that the cash of $355,247.75 was received in 1928 by Crandall stockholders for their Crandall stock. (R. 21) This fact is admitted by the petitioner. (Pet. brief, p. 5) This cash exceeded the earnings of Crandall, the larger predecessor. (R. 21, Pet. brief, p. 5) Henderson shareholders

received only shares of the new company and Henderson had earnings of $74,743.62.

The majority of the Circuit Court of Appeals concluded that separate treatment of Henderson's earnings would serve no purpose, and is not justified, in a single transaction reorganization where "only the total earnings and profits arrived at upon its conclusion appears pertinent." (R. 42, footnote 2) Holding to the contrary, the dissenting Judge concludes that Henderson's earnings were transferred to the new company, and suggests remand to the Tax Court to determine whether enough Henderson earnings were still on hand to cover the 1940 distribution. (R. 46)

The stipulation of facts was drawn in anticipation of this question. The parties agreed on the facts which they considered essential to its determination in paragraphs 3 (R. 9) and 10 (R. 14) of the stipulation. Resolving the question of the effect on earnings of the acquisition of the corporation's own shares, the parties agreed in paragraph 3 that there were no earnings on hand "accumulated from December 4, 1928 to December 31, 1939." (R. 9) On the same theory, paragraph 10 of the stipualtion (R. 14) supports the conclusion (as argued on brief to the Tax Court) that what may have been left of Henderson's earnings at December 31, 1939 was distributed and lost in 1940 without considering the June, 1940 distribution.

There is no logical alternative to the assumption that the Tax Court did consider the possible result of the transfer to the new company of Henderson's earnings without transfer of Crandall's earnings.

It is also logical to assume from the result either that the Tax Court found it necessary, in sustaining the tax, to include Crandall's earnings, or that the Tax Court viewed the reorganization as a single transaction.

The Tax Court's conclusion disregarded the facts.

Aside from the fact that the shareholders of the predecessor companies acquired less than a majority of the shares of the new company, the case is controlled by the fact that the new company had, prior to 1940, distributed all of the accumulated earnings of the predecessor companies. This fact is implicit in the Tax Court's findings that:

(a) The new company acquired all the assets of the predecessors "in exchange for 24,131 shares of its capital stock and $355,247.75 in cash"; (R. 21)

(b) This stock and cash were received by stockholders of the predecessors in exchange for their stock therein; (R. 21)

(c) The stockholders of the old corporations exchanged their stock in the old corporations for stock in the new company and money; (R. 22)

(d) The cash which was paid to shareholders of Crandall ($355,247.75) exceeded its earnings and profits; (R. 21) and in the admitted facts that

(e) All except $30.00 of this cash was in full payment in exchange for 1017½ shares of Crandall

stock, par value $10.00 per share (R. 11-14, petitioner's brief, page 5.)

(f) The new company in 1940 had no accumulated earnings or profits of its own (R. 9) and

(g) The new company in 1940 distributed to its shareholders (excluding the disputed distribution) more than the amount of the 1928 earnings and profits of Henderson. (R. 14, 21, 22).

The applicable and governing statutes and regulations require the conclusion that the 1940 disputed distribution was a return of capital under Sec. 115 (d) of the Internal Revenue Code. The decision of the Circuit Court of Appeals should therefore be affirmed.

Respectfully submitted,

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APPENDIX.

Revenue Act of 1924, c. 234, 43 Stat. 253:

SEC. 203. RECOGNITION OF GAIN OR LOSS FROM SALES AND EXCHANGES.

* * * * * * *

(c) If there is distributed, in pursuance of a plan of reorganization, to a shareholder in a corporation a party to the reorganization, stock or securities in such corporation or in another corporation a party to the reorganization, without the surrender by such shareholder of stock or securities in such a corporation, no gain to the distributee from the receipt of such stock or securities shall be recognized.

* * * * * * *

(g) The distribution, in pursuance of a plan of reorganization, by or on behalf of a corporation a party to the reorganization, of its stock or securities or stock or securities in a corporation a party to the reorganization, shall not be considered a distribution of earnings or profits within the meaning of subdivision (b) of section 201 for the purpose of determining the taxability of subsequent distributions by the corporation.

* * * * * * *

Report of Ways and Means Committee, 68th Congress, 1st Session, H. Rept. 179:

page 14—

There is no provision of the existing law which corresponds to subdivision (c). Under the existing law, if corporation A organizes a subsidiary, corporation B, to which it transfers part of its assets

in exchange for all the stock of corporation B, and distributes the stock of corporation B as a dividend to its stockholders without the surrender by the stockholders of any of their stock, then such a dividend is a taxable one. If, however, corporation A organizes two new corporations, corporations B and C, and transfers part of its assets to corporation B and part to corporation C, and the stockholders of corporation A surrender their stock and receive in exchange therefor stock of corporations B and C, no gain from the transaction is recognized. Thus, under the existing law, the same result, except as to tax liability, may be obtained by either of two methods; but if the first method set out above is adopted, the gain is taxable, while if the second method set out above is adopted, there is no taxable gain. Subdivision (c) of the bill permits the reorganization to be accomplished in the first manner set out above without the recognition of gain. This method represents a common type of reorganization and clearly should be included within the reorganization provisions of the statute as long as the exemption under the present law is continued.

page 16—

There is no provision of the existing law which corresponds to subdivision (g). This subdivision provides that a distribution by a corporation in connection with a reorganization of stock or securities in another corporation, a party to the reorganization, shall not be considered a distribution of earnings and profits for the purpose of determining the taxability of subsequent distributions by the corporation.

It should be noted that this subdivision covers the case in which A distributes the stock of B as a dividend, the case in which A distributes the stock of B in retirement of a portion of its (A's) stock, and the case in which B issues its stock direct to A's stockholders in the course of a reorganization.

Revenue Act of 1928, c. 852, 45 Stat. 791:

SEC. 111. DETERMINATION OF AMOUNT OF GAIN OR LOSS.

(a) *Computation of gain or loss.*—Except as hereinafter provided in this section, the gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the basis provided in section 113, and the loss shall be the excess of such basis over the amount realized.

(b) *Adjustment of basis.*—In computing the amount of gain or loss under subsection (a)—

(1) Proper adjustment shall be made for any expenditure, receipt, loss, or other item, properly chargeable to capital account, and

* * * * * * *

(3) In the case of stock the basis shall be diminished by the amount of distributions previously made in respect of such stock, to the extent provided under the law applicable to the year in which the distribution was made.

(c) *Amount realized.*—The amount realized from the sale or other disposition of property shall be the sum of money received plus the fair market value of the property (other than money) received.

(d) *Recognition of gain or loss.*—In the case of a sale or exchange, the extent to which the gain or loss determined under this section shall be recognized for the purposes of this title, shall be determined under the provisions of section 112.

SEC. 112. RECOGNITION OF GAIN OR LOSS.

(a) *General rule.*—Upon the sale or exchange of property the entire amount of the gain or loss, determined under section 111, shall be recognized, except as hereinafter provided in this section.

(b) *Exchanges solely in kind.*—

* * * * * * *

(3) *Stock for stock on reorganization.*—No gain or loss shall be recognized if stock or securities in a corporation a party to a reorganization are, in pursuance of the plan of reorganization, exchanged solely for stock or securities in such corporation or in another corporation a party to the reorganization.

(4) *Same—Gain of corporation.*—No gain or loss shall be recognized if a corporation a party to a reorganization exchanges property, in pursuance of the plan of reorganization, solely for stock or securities in another corporation a party to the reorganization.

(5) *Transfer to corporation controlled by transferor.*—No gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock or securities in such corporation, and immediately after the exchange such person or persons are in control of

the corporation; but in the case of an exchange by two or more persons this paragraph shall apply only if the amount of the stock and securities received by each is substantially in proportion to his interest in the property prior to the exchange.

(c) *Gain from exchanges not solely in kind.*—

(1) If an exchange would be within the provisions of subsection (b) (1), (2), (3), or (5) of this section if it were not for the fact that the property received in exchange consists not only of property permitted by such paragraph to be received without the recognition of gain, but also of other property or money, then the gain, if any, to the recipient shall be recognized, but in an amount not in excess of the sum of such money and the fair market value of such other property.

(2) If a distribution made in pursuance of a plan of reorganization is within the provisions of paragraph (1) of this subsection but has the effect of the distribution of a taxable dividend, then there shall be taxed as a dividend to each distributee such an amount of the gain recognized under paragraph (1) as is not in excess of his ratable share of the undistributed earnings and profits of the corporation accumulated after February 28, 1913 The remainder, if any, of the gain recognized under paragraph (1) shall be taxed as a gain from the exchange of property.

(d) *Same — gain of corporation.* — If an exchange would be within the provisions of subsection (b) (4) of this section if it were not for the fact that the property received in exchange consists not

only of stock or securities permitted by such paragraph to be received without the recognition of gain, but also of other property or money, then—

(1) If the corporation receiving such other property or money distributes it in pursuance of the plan of reorganization, no gain to the corporation shall be recognized from the exchange, but

(2) If the corporation receiving such other property or money does not distribute it in pursuance of the plan of reorganization, the gain, if any, to the corporation shall be recognized, but in an amount not in excess of the sum of such money and the fair market value of such other property so received, which is not so distributed.

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(g) *Distribution of stock on reorganization.*— If there is distributed, in pursuance of a plan of reorganization, to a shareholder in a corporation a party to the reorganization, stock or securities in such corporation or in another corporation a party to the reorganization, without the surrender by such shareholder of stock or securities in such a corporation, no gain to the distributee from the receipt of such stock or securities shall be recognized.

(h) *Same — effect on future distributions.* — The distribution, in pursuance of a plan of reorganization, by or on behalf of a corporation a party to the reorganization, of its stock or securities or stock or securities in a corporation a party to the reorganization, shall not be considered a distribution of earnings or profits within the meaning of section 115 (b) for the purpose of determining the taxability of subsequent distributions by the corporation.

(i) *Definition of reorganization.* — As used in this section and sections 113 and 115—

(1) The term "reorganization" means (A) a merger or consolidation (including the acquisition by one corporation of at least a majority of the voting stock and at least a majority of the total number of shares of all other classes of stock of another corporation, or substantially all the properties of another corporation), or (B) a transfer by a corporation of all or a part of its assets to another corporation if immediately after the transfer the transferor or its stockholders or both are in control of the corporation to which the assets are transferred, or (C) a recapitalization, or (D) a mere change in identity, form, or place of organization, however effected.

(2) The term "a party to a reorganization" includes a corporation resulting from a reorganization and includes both corporations in the case of an acquisition by one corporation of at least a majority of the voting stock and at least a majority of the total number of shares of all other classes of stock of another corporation.

(j) *Definition of control.* — As used in this section the term "control" means the ownership of at least 80 per centum of the voting stock and at least 80 per centum of the total number of shares of all other classes of stock of the corporation.

SEC. 113. BASIS FOR DETERMINING GAIN OR LOSS.

(a) *Property acquired after February 28, 1913.* — The basis for determining the gain or loss

from the sale or other disposition of property acquired after February 28, 1913, shall be the cost of such property; except that—

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(b) *Property acquired before March 1, 1913.* —The basis for determining the gain or loss from the sale or other disposition of property acquired before March 1, 1913, shall be:

(1) the cost of such property (or, in the case of such property as is described in subsection (a) (1), (4), (5), or (12) of this section, the basis as therein provided), or

(2) the fair market value of such property as of March 1, 1913, whichever is greater. In determining the fair market value of stock in a corporation as of March 1, 1913, due regard shall be given to the fair market value of the assets of the corporation as of that date.

SEC. 115. DISTRIBUTIONS BY CORPORATIONS.

(a) *Definition of dividend.* — The term "dividend" when used in this title (except in section 203(a) (4) and section 208(c) (1), relating to insurance companies) means any distribution made by a corporation to its shareholders, whether in money or in other property, out of its earnings or profits accumulated after February 28, 1913.

(b) *Source of distributions.* — For the purposes of this Act every distribution is made out of earnings or profits to the extent thereof, and from the most recently accumulated earnings or profits. Any earnings or profits accumulated, or increase in

value of property accrued, before March 1, 1913, may be distributed exempt from tax, after the earnings and profits accumulated after February 28, 1913, have been distributed, but any such tax-free distribution shall be applied against and reduce the basis of the stock provided in section 113.

(c) *Distributions in liquidation.* — Amounts distributed in complete liquidation of a corporation shall be treated as in full payment in exchange for the stock, and amounts distributed in partial liquidation of a corporation shall be treated as in part or full payment in exchange for the stock. The gain or loss to the distributee resulting from such exchange shall be determined under section 111, but shall be recognized only to the extent provided in section 112. In the case of amounts distributed in partial liquidation (other than a distribution within the provisions of section 112(h) of stock or securities in connection with a reorganization) the part of such distribution which is properly chargeable to capital account shall not be considered a distribution of earnings or profits within the meaning of subsection (b) of this section for the purpose of determining the taxability of subsequent distributions by the corporation.

(d) *Other distributions from capital.* — If any distribution (not in partial or complete liquidation) made by a corporation to its shareholders is not out of increase in value of property accrued before March 1, 1913, and is not out of earnings or profits, then the amount of such distribution shall be applied against and reduce the basis of the stock provided in section 113, and if in excess of such

basis, such excess shall be taxable in the same manner as a gain from the sale or exchange of property. The provisions of this subsection shall also apply to distributions from depletion reserves based on the discovery value of mines.

* * * * * * *

(h) *Definition of partial liquidation.* — As used in this section the term "amounts distributed in partial liquidation" means a distribution by a corporation in complete cancellation or redemption of a part of its stock, or one of a series of distributions in complete cancellation or redemption of all or a portion of its stock.

Revenue Act of 1932, c. 209, 47 Stat. 169:

SEC. 112. RECOGNITION OF GAIN OR LOSS.

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(h) *Same—Effect on future distributions.*— The distribution, in pursuance of a plan of reorganization, by or on behalf of a corporation a party to the reorganization, of its stock or securities or stock or securities in a corporation a party to the reorganization, if no gain to the distributee from the receipt of such stock or securities was recognized by law, shall not be considered a distribution of earnings or profits within the meaning of section 115(b) for the purpose of determining the taxability of subsequent distributions by the corporation.

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Revenue Act of 1934, c. 277, 48 Stat. 680:

SEC. 112. RECOGNITION OF GAIN OR LOSS.

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(b) *Exchanges solely in kind.* — (Added by Sec. 110(a), Revenue Act of 1935, c. 829, 49 Stat. 1014.)

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(6) *Exchange in liquidation.*—No gain or loss shall be recognized upon the receipt by a corporation of property (other than money) distributed in complete liquidation of another corporation,

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SEC. 115. DISTRIBUTIONS BY CORPORATIONS.

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(h) *Distribution of stock on reorganization—Effect on future distributions.*—The distribution before January 1, 1934, in pursuance of a plan of reorganization, by or on behalf of a corporation a party to the reorganization, of its stock or securities or stock or securities in a corporation a party to the reorganization, if no gain to the distributee from the receipt of such stock or securities was recognized by law, shall not be considered a distribution of earnings or profits within the meaning of this section for the purpose of determining the taxability of subsequent distributions by the corporation. As used in this subsection, the terms "reorganization" and "party to the reorganization" shall have the meanings assigned to such terms in section 112 of the Revenue Act of 1932.

Revenue Act of 1936, c. 690, 49 Stat. 1648.

SEC. 112. RECOGNITION OF GAIN OR LOSS.

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(b) *Exchanges solely in kind.*—

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(6) *Property received by corporation on complete liquidation of another.*—No gain or loss shall be recognized upon the receipt by a corporation of property distributed in complete liquidation of another corporation.

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Revenue Act of 1938, c. 289, 52 Stat. 447.

SEC. 115. DISTRIBUTIONS BY CORPORATIONS.

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(h) *Effect on earnings and profits of distributions of stock.*—The distribution (whether before January 1, 1938, or on or after such date) to a distributee by or on behalf of a corporation of its stock or securities, or stock or securities in another corporation, or of property or money, shall not be considered a distribution of earnings or profits of any corporation—

(1) if no gain to such distributee from the receipt of such stock or securities, property or money, was recognized by law, * * *

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Internal Revenue Code:

SEC. 112. RECOGNITION OF GAIN OR LOSS.

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(g) *Definition of reorganization.*—As used in this section (other than subsection (b) (10) and

subsection (1)) and in section 113 (other than subsection (a) (22)).—

(1) The term "reorganization" means (A) a statutory merger or consolidation, or (B) the acquisition by one corporation, in exchange solely for all or a part of its voting stock, of at least 80 per centum of the voting stock and at least 80 per centum of the total number of shares of all other classes of stock of another corporation, or (C) the acquistion by one corporation, in exchange solely for all or a part of its voting stock, of substantially all the properties of another corporation, but in determining whether the exchange is solely for voting stock the assumption by the acquiring corporation of a liability of the other, or the fact that property acquired is subject to a liability, shall be disregarded, or (D) a transfer by a corporation of all or a part of its assets to another corporation if immediately after the transfer the transferor or its shareholders or both are in control of the corporation to which the assets are transferred, or (E) a recapitalization, or (F) a mere change in identity, form, or place of organization, however effected.

(2) The term "a party to a reorganization" includes a corporation resulting from a reorganization and includes both corporations in the case of a reorganization resulting from the acquisition by one corporation of stock or properties of another.

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SEC. 115. DISTRIBUTIONS BY CORPORATIONS.

(a) *Definition of Dividend.* — The term "dividend" when used in this chapter (except in section 203 (a) (3) and section 207 (c) (1), relating to

insurance companies) means any distribution made by a corporation to its shareholders, whether in money or in other property, (1) out of its earnings or profits accumulated after February 28, 1913, or (2) out of the earnings or profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made.

(b) *Source of Distributions.* — For the purposes of this chapter every distribution is made out of earnings or profits to the extent thereof, and from the most recently accumulated earnings or profits. Any earnings or profits accumulated, or increase in value of property accrued, before March 1, 1913, may be distributed exempt from tax, after the earnings and profits accumulated after February 28, 1913, have been distributed, but any such tax-free distribution shall be applied against and reduce the adjusted basis of the stock provided in section 113.

(c) *Distribution in Liquidation.* — Amounts distributed in complete liquidation of a corporation shall be treated as in full payment in exchange for the stock, and amounts distributed in partial liquidation of a corporation shall be treated as in part or full payment in exchange for the stock. The gain or loss to the distributee resulting from such exchange shall be determined under section 111, but shall be recognized only to the extent provided in section 112. In the case of amounts distributed (whether before January 1, 1939, or on or after such date) in partial liquidation (other than a distribu-

tion to which the provisions of subsection (h) of this section are applicable) the part of such distribution which is properly chargeable to capital account shall not be considered a distribution of earnings or profits. * * *

(d) *Other Distributions From Capital.* — If any distribution made by a corporation to its shareholders is not out of increase in value of property accrued before March 1, 1913, and is not a dividend, then the amount of such distribution shall be applied against and reduce the adjusted basis of the stock provided in section 113, and if in excess of such basis, such excess shall be taxable in the same manner as a gain from the sale or exchange of property. * * *

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(i) *Definition of Partial Liquidation.* — As used in this section the term "amounts distributed in partial liquidation" means a distribution by a corporation in complete cancellation or redemption of a part of its stock, or one of a series of distributions in complete cancellation or redemption of all or a portion of its stock.

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Treasury Regulations 103, promulgated under the Internal Revenue Code:

SEC. 19.112(g)-1. *Purpose and scope of exception of reorganization exchanges.* * * *

Purpose: Under the general rule, upon the exchange of property, gain or loss must be accounted for if the new property differs in a material particular, either in kind or in extent, from the old property. The purpose of the reorganization pro-

visions of the Internal Revenue Code is to except from the general rule certain specifically described exchanges incident to such readjustments of corporate structures, made in one of the particular ways specified in the Code, as are required by business exigencies, and which effect only a readjustment of continuing interests in property under modified corporate forms. Requisite to a reorganization under the Code are a continuity of the business enterprise under the modified corporate form, and a continuity of interest therein on the part of those persons who were the owners of the enterprise prior to the reorganization. The Code recognizes as a reorganization the change (made in a specified way) from a business enterprise conducted by a single corporation to the same business enterprise conducted by a parent and a subsidiary corporation, but not the creation of a temporary subsidiary as a device for the making of an ordinary dividend. The Code recognizes as a reorganization the amalgamation (occurring in a specified way) of two corporate enterprises under a single corporate structure if there exists among the holders of the stock and other securities of either of the old corporations the requisite continuity of interest in the new corporation, but there is not a reorganization if the holders of the stock and securities of the old corporation are merely the holders of short-term notes in the new corporation. In order to exclude transactions not intended to be included, these specifications of the reorganization provisions of the law are precise. Both the terms of the specifications and their underlying assumptions and purposes must be satisfied in order to entitle the taxpayer

to the benefit of the exception from the general rule. Accordingly, under the Code, a short-term purchase money note is not a security of a party to a reorganization, an ordinary dividend is to be treated as an ordinary dividend, and a sale is nevertheless to be treated as a sale, even though the mechanics of a reorganization have been set up.

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SEC. 19.112(g)-2. *Definition of Terms.* — The application of the term "reorganization" is to be strictly limited to the specific transaction set forth in section 112(g)(1). The term does not embrace the mere purchase by one corporation of the properties of another corporation, for it imports a continuity of interest on the part of the transferor or its stockholders in the properties transferred. If the properties are transferred for cash and deferred payment obligations of the transferee evidenced by short-term notes, the transaction is a sale and not an exchange. * * *

SEC. 19.115-2. *Sources of distributions in general.*—For the purpose of income taxation every distribution made by a corporation is made out of earnings or profits to the extent thereof and from the most recently accumulated earnings or profits. In determining the source of a distribution, consideration should be given *first*, to the earnings or profits of the taxable year; *second*, to the earnings or profits accumulated since February 28, 1913, only in the case where, and to the extent that, the distributions made during the taxable year are not regarded as out of the earnings or profits of that year; *third*, to the earnings or profits accumulated prior to March 1, 1913, only after all the earnings

or profits of the taxable year and all the earnings or profits accumulated since February 28, 1913, have been distributed; and, *fourth*, to sources other than earnings or profits only after the earnings or profits have been distributed.

* * * The portion of each such distribution which is not regarded as out of earnings or profits of the taxable year shall be considered a taxable dividend to the extent of the earnings or profits accumulated since February 28, 1913, and available on the date of the distribution. In any case in which it is necessary to determine the amount of earnings or profits accumulated since February 28, 1913, and the actual earnings or profits to the date of a distribution within any taxable year (whether beginning before January 1, 1936, or, in the case of an operating deficit, on or after that date) cannot be shown, the earnings and profits for the year (or accounting period, if less than a year) in which the distribution was made shall be prorated to the date of the distribution not counting the date on which the distribution was made.

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SEC. 19.115-5. *Distributions in liquidation.*

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(c) *Partial liquidation.*—

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The term "amounts distributed in partial liquidation" means a distribution by a corporation in complete cancellation or redemption of a part of its stock, or one of a series of distributions in complete cancellation or redemption of all or a portion of its stock. A complete cancellation or redemption of a part of the corporate stock may be accom-

plished, for example, by the complete retirement of all the shares of a particular preference or series, or by taking up all the old shares of a particular preference or series and issuing new shares to replace a portion thereof, or by the complete retirement of any part of the stock, whether or not pro rata among the shareholders.

In the case of amounts distributed in partial liquidation, the part of such distribution which is properly chargeable to capital account shall not be considered a distribution of earnings or profits within the meaning of section 115(b) for the purpose of determining taxability of subsequent distributions by the corporations. (See sections 19.27(g)-1 and 19.115-11.)

SEC. 19.27(g)-1. *Dividends paid credit for distribution in liquidation.*

(2) *Distributions which diminish earnings or profits.* — * * * Thus, a distribution either in complete or partial liquidation of a corporation is treated by the Code as one constituting in part a distribution of, and being properly chargeable to, earnings or profits, if—

(1) Under the provisions of section 115(c), the amounts distributed in liquidation are treated as received in payment in exchange for the stock; and

(2) Under the provisions of section 112, the gain or loss, if any, from such exchange is recognized * * *.

In such a case, an allowance for dividends paid may be included in the basic surtax credit for the amount actually involved in such distribution which is prop-

erly chargeable to the earnings or profits accumulated after February 28, 1913, even though the method of taxation of the distribution is that ordinarily employed with respect to the gain or loss realized and recognized upon an exchange, rather than that employed with respect to a taxable dividend.

On the other hand, certain transactions described in sections 112 and 115 are treated, for the purposes of the Internal Revenue Code, not as distributions to the shareholders of earning or profits, but as transfers of such earnings or profits intact to another corporation in whose hands such earnings or profits, being available for distribution by it as dividends to its shareholders, have essentially the same status for the purposes of the Code as earnings or profits derived from its own operations. Characteristic of these transactions is the circumstance that the gain or loss realized from the receipt by the shareholders of property is not recognized by the Code. No allowance for dividends paid is permissible with respect to such transactions.

(b) *Amount properly chargeable to earnings or profits.* —

In the case of a distribution in liquidation with respect to which an allowance for dividends paid is permissible (see paragraph (a) of this section) the amount of the allowance is equal to the part of such distribution which is properly chargeable to the earnings or profits accumulated after February 28, 1913. To determine the amount properly chargeable to the earnings or profits accumulated since February 28, 1913, there must be deducted from the

amount of the distribution that part allocable to capital account. The capital account, for purposes of these regulations, includes not only amounts representing the par or stated value of the stock with respect to which the liquidating distribution is being made but also that stock's proper share of the paid-in surplus, and such other corporate items, if any, which for purposes of income taxation, are treated like capital in that they are not taxable dividends when distributed but are applied against and reduce the basis of the stock. The remainder of the distribution in liquidation is, ordinarily, properly chargeable to the earnings or profits accumulated since February 28, 1913.

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SEC. 19.115-11. (as amended by T. D. 5299, 1943-1 Cum. Bull. 747) *Effect on earnings or profits of certain tax-free exchanges and tax-free distributions.*—If, under the law applicable to the year in which any transfer or exchange of property after February 28, 1913, was made (including transfers in connection with a reorganization or a complete liquidation under section 112(b)(6) and intercompany transfers of property during a period of affiliation), gain or loss was not recognized (or was recognized only to the extent of the property received other than that permitted by such law to be received without the recognition of gain), then proper adjustment and allocation of the earnings or profits of the transferor shall be made as between the transferor and transferee corporations.

If a transaction described in the preceding paragraph has occurred, there shall be included in the accumulated earnings and profits of the trans-

feree corporation as of the day on which such transaction occurred the proportionate part of any earnings and profits of the transferor corporation accumulated as of such day and properly allocable to the transferee; and there shall be included in the current earnings and profits of the transferee for the taxable year of the transferee in which such transaction occurred the proportionate part of the earnings and profits of the transferor accumulated after the beginning of such taxable year and properly allocable to the transferee. The amount so included in the current earnings and profits of the transferee shall not exceed such proportionate part of the earnings and profits of the transferor accumulated as of the day on which such transaction occurred.

The general rule provided in section 115(b) that every distribution is made out of earnings or profits to the extent thereof and from the most recently accumulated earnings or profits, does not apply to:

(1) The distribution, in pursuance of a plan of reorganization, by or on behalf of a corporation a party to the reorganization, to its shareholders of stock or securities in such corporation or in another corporation a party to the reorganization—

(A) in any taxable year beginning before January 1, 1934, without the surender by the distributees of stock or securities in such corporation (see section 112(g) of the Revenue Act of 1932); or

(B) in any taxable year (beginning before January 1, 1939, or on or after such date) in ex-

change for its stock or securities (see section 112(b)(3)) if no gain to the distributees from the receipt of such stock or securities was recognized by law.

(2) The distribution in any taxable year (beginning before January 1, 1939, or on or after such date) of stock or securities, or other property or money to a corporation in complete liquidation of another corporation, under the circumstances described in section 112(b)(6) of the Revenue Act of 1936; or of the Revenue Act of 1938, or of the Internal Revenue Code.

(3) The distribution in any taxable year (beginning after December 31, 1938) of stock or securities, or other property or money, in the case of any exchange or distribution described in section 371 (relating to exchanges and distributions in obedience to orders of the Securities and Exchange Commission), if no gain to the distributees from the receipt of such stock, securities, or other property or money was recognized by law.

(4) A stock dividend which was not subject to tax in the hands of the distributee because either it did not constitute income to him within the meaning of the sixteenth amendment to the Constitution or because exempt to him under section 115(f) of the Revenue Act of 1934 or a corresponding provision of a prior Revenue Act.

A distribution described in paragraph (1), (2), (3), or (4) above does not diminish the earnings or profits of any corporation. In such cases, the earnings or profits remain intact and available for

distribution as dividends by the corporation making such distribution, or by another corporation to which the earnings or profits are transferred upon such reorganization or other exchange. In the case, however, of amounts distributed in liquidation (other than a tax-free liquidation or reorganization described in paragraph (1), (2), (3), or (4) above) the earnings or profits of the corporation making the distribution are diminished by the portion of such distribution properly chargeable to earnings or profits accumulated after February 28, 1913, after first deducting from the amount of such distribution the portion thereof allocable to capital account.

For the purposes of this section, the terms "reorganization" and "party to the reorganization" shall, for any taxable year beginning before January 1, 1934, have the meanings assigned to such terms in section 112 of the Revenue Act of 1932; for any taxable year beginning after December 31, 1933, and before January 1, 1936, have the meanings assigned to such terms in section 112 of the Revenue Actof 1934; for any taxable year beginning after December 31, 1935, and before January 1, 1938, have the meanings assigned to such terms in section 112 of the Revenue Act of 1936; and for any taxable year beginning after December 31, 1937, and before January 1, 1939, have the meanings assigned to such terms in section 112 of the Revenue Act of 1938.